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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series

One Year Later: Some Comments on the International Economic Situation on 15 August 1972

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1972

INTELLIGENCE MEMORANDUM

ONE YEAR LATER: SOME COMMENTS ON THE INTERNATIONAL ECONOMIC SITUATION ON 15 AUGUST 1972

Summary and Conclusions

1. The Smithsonian currency realignment has not yet had its expected impact on international trade. More rapid US growth relative to that of our major trade partners has made it difficult to reduce the US trade deficit and foreign surpluses. The US merchandise trade deficit and the West German and Japanese surpluses increased substantially in the first half of 1972, compared with the same period last year.

2. Short-term capital flows also have not responded to the realignment as expected. An attack on the US dollar following the float of the British pound in June overshadowed an earlier improvement in the US short-term capital account. This run apparently reflected a continuing feeling on the part of international money managers that there is less exchange risk in holding Deutsche marks, Swiss francs, Dutch guilders, and Japanese yen than US dollars.

3. The durability of the Smithsonian agreement is likely to be tested again later this year. There is no evidence that a sharp reversal of current trade balance trends is imminent, and revised forecasts, adjusted to reflect relatively more rapid US growth, indicate the US trade deficit in 1972 will be in excess of $6 billion. This deficit will almost certainly increase speculative pressures and possibly lead to another run on the dollar.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Discussion

Background

4. The deteriorating US balance of payments in 1970 and the first half of 1971 weakened foreign confidence in the dollar and in the stability of the international economic system. The US trade balance was shifting from surplus to large deficits, and, with low interest rates to aid economic recovery at home, there was a steady outflow of dollars to those countries with higher rates, especially West Germany. The dollar outflow accelerated in the spring of 1971 as rumors of foreign revaluations intensified. Speculation reached fever pitch on 5 May; in Germany about $1 billion was converted into Deutsche marks in one hour.

5. Substantial adjustments in the international economic system were obviously needed. The central banks of Germany, the Netherlands, Belgium, Switzerland, and Austria suspended trading in an effort to stem speculative inflows; the Deutsche mark and Dutch guilder were subsequently allowed to float above their previous dollar parity; the Swiss franc and the Austrian schilling were revalued; and Brussels allowed the Belgian franc to float with respect to capital, but not commercial, transactions. Speculative pressures slackened somewhat in May and June, but statements by foreign officials suggesting that further revaluations were needed acted to reaccelerate movements into convertible currencies other than the dollar. Consequently, on 15 August, President Nixon announced the United States would close the gold window and seek to reduce its trade deficit in order to restore stability to the international economic system. In response to the New Economic Policy, the major European countries and Japan floated their currencies under varying forms of control, with official intervention or two-tier systems restricting the float's competitive impact on trade.

6. International economic uncertainties increased. Major foreign currencies appreciated in terms of the dollar through the fall, but the appreciations were generally thought to be inadequate. On 18 December, however, at the Smithsonian conference, the Group of Ten financial powers[1] and Switzerland reached agreement on a major realignment of currencies. The realignment resulted in a 7.9% devaluation of the US dollar relative to gold and a substantial revaluation of major world currencies relative to the dollar, ranging from 7.5% in the case of Italy and the Scandinavian countries to 16.9% in the case of Japan. The agreement also

1. The United States, Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and West Germany.

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provided for enlargement of the intervention limits – wider bands – from 1% to 2.25% on either side of the new central rate as an added deterrent to speculation.

Recent Trade Developments

7. The Smithsonian currency realignment was expected to improve the US trade account substantially, by roughly $8 billion within about two years, with most of the improvement coming at the expense of Japan and West Germany. This anticipated turnaround has not yet developed. Actually, in the first half of 1972 the trade balance of only one major OECD country, Canada, was closer to balance (the absolute size of the trade balance was smaller) than in the first half of 1971 (see Table 1). The seasonally adjusted US trade deficit in the first half of 1972, about $3.3 billion, was substantially greater than the record deficit in the second half of 1971, $2.0 billion, and extraordinarily greater than the $700 million deficit in the same period last year. Similarly, in the first half of 1972, the seasonally adjusted Japanese trade surplus, $5.1 billion, and the German trade surplus, $4.2 billion, were substantially larger than the surpluses of $4.0 billion and $3.0 billion, respectively, of a year ago.

8. Lags associated with the exchange rate adjustment have apparently had their expected perverse short-run impact on the trade balances. The parity adjustments produced an immediate adverse impact on the US terms of trade. The dollar price of US imports rose more rapidly (at a rate of about 4%) than the dollar price of US exports (which rose about 1%) with little if any impact on import and export growth in quantity (see Table 2).

9. The poor US trade performance in the first half of 1972 is also attributable to continuing differences in phase between the US and West European and Japanese economies. The economic slow-downs in Western Europe, which continued through most of the first half of the year, depressed import demand there, while the economic recovery in Japan was not sufficiently advanced to stimulate demand much beyond what could be satisfied from existing inventories (see Table 3).(2)

10. By comparison, real GNP growth in the United States was the fastest in seven years. As a consequence the quantity of imports increased more than 20% in the first quarter of 1972, compared with the same period in 1971. Imports of machinery and transport equipment, petroleum products, and consumer goods grew especially fast. US imports from the

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Table 1

Trade Balances for Selected OECD Countries a/

Million US $

	1971		1972 b/
	1st Half	2nd Half	1st Half
Canada			
Balance	1,360	1,050	700
Exports	9,000	9,370	9,850
Imports	7,640	8,320	9,150
France			
Balance	600	500	600
Exports	9,950	10,850	12,300
Imports	9,350	10,350	11,700
Italy			
Balance	-190	520	700
Exports	7,060	7,770	8,800
Imports	7,260	7,240	8,100
Japan			
Balance	3,980	4,190	5,130
Exports	12,100	11,830	14,170
Imports	8,125	7,640	9,040
United Kingdom			
Balance	110	620	-450
Exports	10,270	11,370	11,850
Imports	10,160	10,750	12,300
United States			
Balance	-720	-1,970	-3,340
Exports	21,730	21,040	23,620
Imports	22,450	23,010	26,960
West Germany			
Balance	3,020	3,340	4,150
Exports	18,630	20,230	22,400
Imports	15,610	16,890	18,250

a. Seasonally adjusted. Because of rounding, components may not add to the totals shown.

b. The data are Organization for Economic Cooperation and Development (OECD) estimates, except for Japan and the United States, for which data are preliminary.

Table 2

Changes in Export and Import Dollar Prices and Quantities for Selected OECD Countries First Quarter of 1972 over First Quarter of 1971

		Percent
	Prices	Quantities
Canada		
Exports	2.4	5.7
Imports	3.4	19.5
France		
Exports	11.2	13.0
Imports	13.8	16.4
Italy		
Exports	7.8	17.3
Imports	9.3	2.7
Japan		
Exports	13.6	8.2
Imports	9.3	2.0
United Kingdom		
Exports	16.9	7.1
Imports	12.6	8.6
United States		
Exports	0.8	6.4
Imports	4.0	22.3
West Germany		
Exports	16.7	5.1
Imports	9.0	10.3

European Community (EC), Japan, and Canada all grew rapidly. Part of this growth, however, can also be explained by the recovery from the 1971 dock strike as the growth in reported foreign exports to the United States in the period is significantly slower than the growth in US imports.

11. Overall, recent trade developments have not been significantly worse than anticipated at the time of the Smithsonian agreement. Improvement in the US trade balance was expected to be slow in coming because of the economic slow-down abroad, the economic recovery in the United States, and the usual lags before the parity changes are fully reflected in changes in the trade balances. Working Party Three of the OECD Economic Policy Committee predicted that the seasonally adjusted US trade account deficit would be approximately \$2 billion in the first half of 1972; the CIA [redacted] which assumed that the parity changes would have no impact on the trade balances in the first six months of the year, indicated that deficit would be about \$3 billion; the actual seasonally adjusted US trade account deficit was \$3.3 billion (see Table 4). Only in the case of the United Kingdom, which incurred a \$500 million deficit rather than the expected \$500 million surplus, was the actual seasonally adjusted trade balance significantly different from the average of the OECD and CIA [redacted] forecasts. The poor trade performance of the United Kingdom can be explained by the very rapid increase in UK dollar export prices. Those prices rose an extraordinary 17%, or more rapidly than the dollar export prices of any country, including Japan and West Germany, which had revalued substantially more.

12. It seems unlikely that the improvement in the US trade account in the second half of this year will be as great as was anticipated at the time of the Smithsonian agreement. Working Party Three of the OECD had predicted that the seasonally adjusted deficit would decline about \$600 million to \$1.4 billion in the second half of 1972, while the CIA Trade Model showed a \$2.3 billion improvement for only a \$700 million deficit. Similarly, the Japanese surplus was expected to decline between \$100 million and \$500 million and the West German surplus between \$100 million and \$400 million. Preliminary trade statistics through July, however, show no sharp reversal in past trends, and there are no indications in contracts, acceptances, etc. that a substantial shift in trade patterns is imminent.

13. Adjusting the growth rates assumed in the balance-of-payments forecasts made after the Smithsonian realignment to reflect more rapid US growth negates the expected improvement. The CIA Trade Model, for example, now shows an overall 1972 US trade deficit of \$6.4 billion (see

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Table 3

Real Growth in Gross National Product
for Selected OECD Countries a/
First Half of 1972

	Percent
Canada	5¼
France	5
Italy	2¾
Japan	7
United Kingdom	-¼
United States	7
West Germany	3¼

a. Seasonally adjusted annual average change from the previous half year. OECD estimates except for the United States, which is preliminary, and Italy, which is a CIA estimate.

Table 4

Actual and Forecasted Trade Balances
for Selected OECD Countries a/
First Half of 1972

Million US $

	Actual b/	Forecast OECD	Forecast CIA Trade Model
Canada	700	1,100	1,300
France	600	700	500
Italy	700	600	600
Japan	5,130	4,950	4,000
United Kingdom	-450	500	500
United States	-3,340	-2,000	-3,000
West Germany	4,150	3,700	5,000

a. Seasonally adjusted.
b. OECD estimates, except for Japan and the United States, for which data are preliminary.

Table 5), compared with an expected $3.7 billion deficit before the growth adjustment. The latest US balance-of-payments forecast prepared on the basis of trade data through July is for a US merchandise trade deficit of more than $6 billion in calendar year 1972.

Table 5

CIA Trade Model Trade Balance Forecasts for Selected OECD Countries Revised Growth Rates 1972

	Trade Balance Forecasts (Million US $)	Real Growth in Assumed Gross National Product (Percent)
Canada	3,088	6.1
France	1,060	5.1
Italy	1,111	4.3
Japan	7,560	7.3
United Kingdom	3,232	1.5
United States	-6,448	7.3
West Germany	8,602	3.4

Recent Monetary Developments

14. Many monetary experts expected that much of the massive dollar outflow of 1971, estimated at about $20 billion, would be repatriated in the months following the Smithsonian currency realignment. The US deficit on official settlements exceeded $30 billion in 1971, or about $20 billion more than the basic balance deficit. After adjusting for the decrease in US currency assets and for other factors, this implies a $20 billion increase in foreign currency reserve assets.(4) Because of double counting and recording errors, the reported increase in foreign currency reserve assets was somewhat more, about $30 billion for the non-Communist countries

4. The US official settlements deficit, and the increase in foreign currency reserve assets, would have probably been even greater in 1971 were it not for the special measures undertaken by Japan, Canada, and several of the European countries to reduce their currency reserves. The Japanese, who have been especially interested and successful in hiding their reserves shifted more than $3 billion from their reserve account into long-term international bonds and into the commercial banks for repayment of short-term loans from foreigners in 1970 and 1971.

(see Table 6). A substantial portion of this increase in foreign currency reserve assets was expected to be unwound and returned to the United States once the exchange markets stabilized.

15. The Smithsonian agreement, together with Congressional passage of the gold bill and greater coincidence among interest rates since February, did result in a net dollar reflow through the first five months of 1972 until the pound float, but the reflow did not begin to approach the size of the massive 1971 outflow. Between mid-March and mid-June (the only period in which exchange markets were relatively stable) the total reflow was about $2 billion. This short-term capital inflow probably resulted in a small US official settlements surplus in April and May despite a continuing poor basic balance performance.

16. The improvement in the US short-term capital account might have been more impressive had not the penalty been imposed on repatriation in the beginning of the year by the wider currency bands and higher European and Japanese interest rates. Immediately after the December accord, many foreign currencies were near their floor, placing a premium on dollar purchases for repatriation equal to the difference between the existing spot rate and the central rate. Moreover, through mid-February the decline in US short-term interest rates was more rapid than the decline in European and Japanese short-term rates, increasing the already unfavorable interest rate differential. Since February this differential has narrowed, and short-term interest rates are now somewhat lower in Japan and many of the European countries than in the United States.

17. In the five weeks after the attack on the British pound in June, the short-term capital gains of the first five months were more than wiped out, despite the narrowing short-term interest rate differential. The dollar came under attack as speculators feared that other countries would follow the British lead. Future floats were expected to result in appreciation of the strong currencies (the Deutsche mark, Swiss franc, and Dutch guilder) and devaluation of the weaker currency (the Italian lira). Reported interventions by European central banks in support of the pound, the lira, and the dollar in the period 20 June - 14 July (the first significant interventions since early March) totaled more than $5 billion (see Table 7).

18. The dollar probably would have come under even greater pressure were it not for the additional controls on capital now in force in most of the European countries and Japan (see Table 8). These controls, which have been imposed to reduce speculative capital movements, raise the cost of speculation. The decision of the EC finance ministers to defend the Smithsonian exchange rates, backed by intervention in the market to purchase dollars, and the small direct US intervention in the market with

Table 6

Foreign Currency Reserve Assets for Selected OECD Countries

Million US $

	Foreign Currency Reserves							Total Reserve Assets
	1970	1971				1972		
	December	March	June	September	December	March	June	June 1972
Total non-Communist	44,465	49,340	55,485	69,415	77,070	81,765	--	--
Of which:								
Canada	3,037	3,167	3,203	3,527	4,074	4,123	4,551	6,218
France	1,257	1,613	1,781	3,033	3,577	3,[illegible]85	4,543	9,398
Italy	2,113	2,644	2,656	3,210	3,030	2,767	2,579	6,431
Japan	3,188	4,285	6,238	11,939	13,783	14,841	14,039	15,844
United Kingdom	1,212	1,711	2,328	3,684	5,099	5,258	--	7,725
United States	629	256	322	250	280	212	457	13,339
West Germany	8,455	10,392	11,199	11,380	12,292	13,445	16,455	22,628

Table 7

Reported Interventions by European Central Banks in Support of the Pound, the Lira, and the Dollar 20 June - 14 July 1972

	Million US $
Belgium	88
France	389
West Germany	2,048
Japan	818
Netherlands	519
Switzerland	1,257
Total	5,119

a Dutch guilder sale in July (the first US intervention since the New Economic Policy) also helped restore confidence in the Smithsonian rates and dampen speculative movements.

19. Exchange markets are likely to continue to be periodically buffeted by large short-term capital movements, and the anticipated dollar reflow is unlikely to materalize through the rest of 1972. Money managers believe that the probability that the dollar will weaken is much greater than the probability that it will strengthen. This attitude gives them little incentive to cash in foreign currency holdings for dollars. There is also some hesitation on the part of foreigners to invest in Wall Street, given its current unpredictability. Only when currency dealers feel the new pattern of exchange and interest rates will in fact restore international payments equilibrium is the massive dollar outflow of 1971 likely to be repatriated.

20. Continued uncertainty about future exchange rates is also exerting upward pressure on the gold price.(5) An especially rapid price rise took place in early summer, with the London price topping $70 per troy ounce in early August before fading somewhat. Speculators obviously feel that there is profit potential in holding gold, but other considerations also have been important. Industrial demand has been rising while South African sales have declined, and there are recurring rumors of an official gold revaluation for intra-EC transactions.

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Table 8

Selected OECD Capital Controls
As of August 1972

	Controls
Belgium-Luxembourg	Limits banks' external liabilities.
Japan	Restricts advance payments for exports.
	Has eased restrictions on repayment of short-term foreign debt.
	Restricts conversion of dollars into yen by foreign banks.
	Has reduced domestic bank reliance on foreign borrowing to finance imports.
	Has doubled to 50% the mandatory reserve requirements on increases in non-resident free yen balances.
Netherlands	Has withdrawn licensing of foreign time deposits.
	Bans interest payments on foreign demand deposits.
Switzerland	Limits foreign purchases of non-public notes.
	Has increased maximum permissible sum for foreign loans offered for subscription on the Swiss market.
	Bans non-resident purchases of Swiss securities or property.
	Levies a 2% quarterly charge on all new deposits of US dollars.
West Germany	Imposes non-interest bearing minimum deposit requirements of up to 50% on foreign borrowings by German corporations.
	Requires Bundesbank approval for sale of Deutsche mark denominated fixed interest securities to foreign investors.

Short-Term Prospects

21. The Smithsonian accords are likely to be tested further during the second half of 1972. Although the factors that have offset the short-term impact of the parity realignment on trade (the adverse shift in the terms of trade, the widely differing cyclical positions of the United States and its major trade partners, and the lag in international trade adjustments) are expected to become less important, there is no evidence that a sharp reversal of past trends is imminent. Revised forecasts, moreover, adjusted to reflect relatively more rapid US growth, indicate that the US merchandise trade deficit in 1972 will be in excess of $6 billion.

22. A deficit of this size will almost certainly fuel speculative pressures and possibly lead to another run on the dollar, particularly given the weak state of the British balance of payments and uncertainties regarding the Italian economy. Foreign financial powers generally appear, however, to agree that current exchange rates should be maintained. Indeed, one clear message arising from the sterling crisis was that other major governments are dedicated to making the existing agreements work. The magnitude of the central bank interventions and the stringency of the new capital controls, introduced on top of existing controls, testify to a deep aversion to further upheavals in the international economy.